NCUA CHAIRMAN DEBBIE MATZ
REMARKS TO CUES DIRECTORS CONFERENCE
DECEMBER 9, 2009

It is a great pleasure to join you, the volunteers of our nation's credit unions, at the 2009 CUES Directors Conference.

I am glad to see such an extraordinary turnout for this year's conference. I realize that the choice of location certainly didn't hurt. Last time I checked, it was 35 degrees in Washington. So when your invitation arrived in my office, it went straight to the top of the pile! ☺

But your participation in this conference is, of course, a testament to much more than the beautiful southern California weather. It's a testament to your dedication – as volunteers – to the short-term perseverance and long-term success of our nation's credit unions.

When most Americans think of the banking and finance industry, volunteerism is just about the last idea that comes to mind. While banks and thrifts are about profits, the non-profit credit union community has always been about <u>people</u>. That's why, in this hour of great economic hardship for America, it is our job to ensure that the financial security of the 90 million credit union members continues to come first.

The 4 years I served as an NCUA Board Member during the Clinton Administration were among the most fulfilling and enjoyable of my career. So when President Obama offered me the honor of returning to NCUA as Chairman, I didn't hesitate before accepting. But I knew from day 1 that I was returning to a much different place, with a much different set of challenges, than those we faced during my previous stint on the board.

Perhaps because we are here in Palm Desert, I am reminded of an old story about the golfer, Lee Trevino. Lee was once asked what you should do if you're caught on the golf course in a thunderstorm.

Lee said, "Go stand in the middle of the fairway and hold up a one iron. Not even God can hit a one iron." ☺

As the 2008 financial meltdown unfolded, we all hoped that credit unions, with our hallmark conservative, non-profit management philosophy designed specifically to avoid risk, would be the one iron in the storm.

By and large, this thesis has proven true. Today, 98% of the 7,700 federally insured credit unions are at least adequately capitalized; 96% are well capitalized. This is, in no small part, a tribute to your outstanding decision-making to largely avoid the risky financial instruments that contributed to the meltdown. Because of you, the foundation of our credit union system remains solid.

However, as much as I would like to report to you that the sky ahead is clear, we all know that this crisis could very well get worse before it gets better. In 2010, we are likely to see capital written-off by corporate credit unions trickle down to retail credit unions. And while capital now stands at a strong 10%, it has declined significantly from 11.8% a year ago. And, the likelihood of continued negative earnings exposes credit unions to the risk of further drain on capital.

Perhaps the greatest cause for concern stems from the growing number and size of credit unions downgraded to CAMEL 4 and 5. Assets in these troubled categories have almost doubled, as have the assets in CAMEL 3, which gives us cause for concern that more trouble still lies ahead. And in the first 11 months of 2009, 24 credit unions failed. Next year, we expect the number of failures to rise.

So we come together this year at a time of unprecedented peril for credit unions. Although the overwhelming number of credit unions are on sound financial ground, the prospect of further losses continues to pose a systemic risk.

And though we can't do anything to change the events of the past, NCUA is doing absolutely everything within our power to safeguard the future. As President Kennedy once noted, when written, the Chinese word for "crisis" is composed of two characters – one represents danger and the other, opportunity.

So I want to spend some time filling you in on what NCUA is doing to ensure that corporate and retail credit unions not only weather this storm, but seize this opportunity to emerge stronger than ever before.

One of these opportunities lies in our efforts to develop a revised corporate rule. Since NCUA announced its intention to revise the corporate rule last year, we have received nearly 500 letters from managers and volunteers like you. Not surprisingly, we received a broad range of viewpoints. We heard about national fields of membership, liquidity functions, payment systems, investment authority and governance. Some wrote to tell us that NCUA had acted too quickly, while others argued that NCUA had not acted quickly enough.

And while the specific suggestions of these many letters varied, virtually all of them were written in a constructive spirit – which is exactly how we took them. We have also held three public town hall meetings – in Missouri, Maryland and California – to hear directly from credit union officials on the revised corporate rule. To those of you who took the time to write or attend any of these meetings, thank you for participating – and I want to assure you that your concerns were heard.

I intend to make listening a hallmark of my tenure. I understand that while all credit unions are united behind the same fundamental people-first governing philosophy, the needs, viewpoints and challenges of each credit union are different. There is no one-sized fits-all approach that will satisfy every credit union equally. But I am confident that if we work together constructively, we are certain to make positive decisions.

And that is exactly what I believe we have accomplished with the new corporate rule we are proposing. We began with a desire that we know you share – that the rule should not be prescriptive. It does not prescribe how many corporates will exist, where they will be located or what services they provide. Those decisions should be with you – and the entire leadership of the retail credit unions that comprise the membership of each corporate. Our main objective is to protect the 90 million credit union members by preventing the corporate issue from becoming a <u>consumer</u> issue.

We will reach this goal by strengthening our regulation in four areas:

First -- **capital standards**. One of the most important lessons we learned from the financial crisis was the importance of each institution's level of capital. The corporates that have found themselves struggling are largely those that started with a modest capitalization and became too dependent on contributed capital from retail credit unions.

In response, we are proposing to significantly strengthen capital requirements by aligning corporates with Basel I capital standards and subjecting them to a leverage capital requirement. Working in tandem, these two requirements would assess both quantifiable and non-quantifiable risk and help ensure strong capital standards going forward.

For the first time, the new rule would require corporates to face prompt corrective action standards in the same way that they apply to all other federally-insured financial institutions in the United States. While our goal is to <u>prevent</u> capital risk, we will also aggressively pursue corrective action when necessary.

While the debate over the proper level for capital requirements will likely continue, it is important to remember that the last time the agency engaged in corporate rulemaking in 2002, some in the industry questioned whether a capital requirement was necessary at all. I am confident that subsequent events close the book on that discussion. I am also confident that the new rule strikes the right balance to ensure fiscal prudence without creating new barriers to success.

Yet I think it is clear to all of us that corporates will not be able to rebuild their capital levels overnight.

The first priority must be to remove what we call "legacy assets" from corporate balance sheets. Several corporates, including U.S. Central, are still holding high concentrations of downgraded securities backed in large part by non-performing mortgages with terms of up to 20 years. These investments will likely continue to cause losses and further deplete corporates' capital until the legacy assets can be repackaged and sold.

We are evaluating all possible options to alleviate this problem. Removing large impairments from corporate balance sheets will be pivotal to allow corporates to rebuild capital through retained earnings.

The rate at which safe capital levels return will also depend on the willingness of retail credit unions to provide additional contributed capital. So if you want to continue receiving services from a corporate, your credit union will likely need to help recapitalize it. Until corporates can rebuild retained earnings, corporates will need to raise almost all of their capital from member credit unions.

I encourage you to become part of this solution. I realize that those of you who direct very large credit unions might be able to access liquidity and payment systems from outside the corporate network. But the vast majority of credit unions will still need a viable corporate network to provide liquidity, settlements, investments, and other services that are critical to credit union operations. So the future of corporate credit unions – as well as retail credit unions – will ultimately depend on all of you.

Taking the unique circumstances of each corporate into account, our rule will provide regulatory milestones of 3, 6 and 10 years to reach the new capital requirements. Here, too, we strike a fair balance of providing a 10-year horizon to achieve necessary results, but also ensuring that the work of rebuilding capital begins immediately by enforcing a 3-year preliminary milestone.

While no rule change can remove legacy assets from the past, this change will help prevent concentrations of high-risk assets in the future. And this is critical not just for the survival of the corporates, but for the continued success of retail credit unions and the 90 million Americans you serve.

The second element of our new corporate rule is **asset liability management**. One of the major risks that corporates face today is the gap between average life of assets and liabilities. To minimize this risk, our new regulation proposes specific asset-liability management requirements intended to keep corporates from concentrating in asset-backed securities with expected lives as long as 20 years.

We are also seeking to prohibit corporate credit unions from accepting funds from a single source that exceeds 10% of that corporate's assets. While this may lead to some challenges for corporates with large clients, it is more important that we manage the liquidity risk posed by too great a reliance on a single lender or depositor.

The third focus of our new corporate rule is **concentration.** This is an issue that I take particularly seriously. In fact, I voted against the corporate rule back in 2002 because I did not think that risk concentration was adequately addressed. Now as we know, indisputably, excessive concentration in one type of asset contributed greatly to corporate losses over the past year. This lapse was even more devastating when compared to the corporates' modest levels of capital.

Knowing what we know now, you can be sure that NCUA will not make the same mistake this time. Our proposal couples explicit sector limits and new asset-liability constraints with limits on overly complex and volatile investments. Our projections have shown that if these new standards had already been in place, they would have mitigated the losses from the current corporate crisis. So, while we will seek regulations that are not overly restrictive, we are confident that we will strike the right balance.

The fourth and final main part of the new rule focuses on **governance.** As you know, there are no national training standards for corporate board members. It is long past time to implement some universal governance standards. The proposed rule would require that all corporate board members hold a position of CEO, CFO or COO at their credit union or other member entity. We feel that this standard will serve as a fitting indicator of experience, expertise and motivation. Of course we are open to comments about this from you, as leaders in volunteer governance.

The four components of the new corporate rule – capital standards, asset liability management, concentration, and governance – will allow corporates to continue responsibly serving the needs of retail credit unions while ensuring that the lessons of the past year are learned and followed.

Ultimately, all of these changes are aimed at the same goal of building a firewall between the financial crisis we face and the individual members we serve. Thus far, the impact of the crisis upon individual members has been very limited – and it's our job to keep it that way.

That is my first priority as Chairman. For though we can survive some measure of capital loss, we cannot survive if the American people lose confidence in credit unions as a safe place to save and borrow money. That is why, beyond the new corporate rule, NCUA is intensely focused on providing strong supervision of retail credit unions.

A central part of that effort can be found in our 2010 budget, which we see as another important opportunity to lay the groundwork for a strong and prosperous future.

It is important to keep in mind, as we discuss this year's budget, that since the year 2000, the NCUA budget has not even kept up with inflation. In fact, every year from 2002 through 2007, the NCUA budget was either cut or stagnant. The natural result was a deterioration of our ability to provide oversight and services to credit unions.

One of the most notable examples of this deterioration has been the shift from a yearly exam cycle to an 18-month cycle. In my view, there is no question that this shift contributed to the number of credit unions that have been downgraded to CAMEL 3, 4 and 5. If we have learned anything over the past years, it is that we must do a better job of early detection so that we can take action to protect any credit union in the early stages of capital decline.

The 2009 NCUA budget began to restore necessary funding with a 12% overall increase. Last month, the NCUA Board approved a 13% increase for 2010.

We are all well aware that each budget increase must be paid for by credit unions themselves. I assure you that NCUA will invest each dollar with extreme care. This is why 73 cents of every dollar will go directly to "boots on the ground" – examiners working with credit unions to safely serve the needs of their members.

I understand that in a difficult economic environment, there is a natural tendency to question a budget increase – even one that compensates for eight years of inadequate funding. So let me tell you about some of the benefits of this budget.

The vast majority of the increase will be allocated toward hiring new oversight staff, including 57 new examiners. This will allow us to get back on track to an annual exam cycle. And not only will we hire new examiners, but we'll now ensure that new and existing staff receive state-of-the-art training to deal with the current issues they face. With the number of troubled credit unions expected to continue rising in 2010, having trained staff to intervene whenever necessary is not a luxury; it is an imperative.

This budget will also allow us to create two critically important new offices: the Office of Consumer Protection and the Office of Chief Economist.

The Office of Consumer Protection will help make certain that credit union members receive the financial education they need to make sound financial decisions. To uphold credit unions' role as consumer-friendly institutions, the new office will review all NCUA regulations to ensure they are consumer-friendly. And the new office will help credit unions reach more consumers by advancing new national field of membership standards.

The Office of the Chief Economist will ensure that while our examiners are in the field putting out fires and protecting individual credit unions, we don't lose sight of the big picture: watching leading indicators, identifying economic trends, and most importantly, alerting examiners to potential problems before they appear on call reports as red flags.

Speaking of red flags, we are seeing more of them on the latest call reports. As a result, our examiners are taking a hard look at four key areas of risk:

- First, we're looking at credit unions that hold fixed-rate long term mortgages on their books. Across our industry, 55% of the fixed-rate loans are sold. The problem is, fixed-rate loans that are not sold are concentrated in certain institutions. I know that the impulse of credit unions is to be close to their members, and that this improves the loan-to-share ratio – but it is a risk. When interest rates go up – notice I said "when, not "if" – those fixed-rate mortgages that are earning relatively high rates now could slip underwater. And then it would be too late to sell them.

- Second, we're looking at indirect lending. Credit unions need to drive their <u>own</u> indirect lending relationships, not simply outsource their loan decisions to auto dealers or third-party vendors. That means your credit union really needs to be doing your own due diligence, pulling the credit reports and practicing sound underwriting. If it's done properly, this is a fine way to grow business. If not, it can be a fine way to steer credit unions into insolvency.

  I have an unfortunate example of what I'm talking about. Not far from here in the southwest, there was a credit union that served primarily minority communities, and it got in over its head with an indirect auto lending program. A combination of inadequate due diligence, lack of monitoring of their third-party vendors, and extremely poor underwriting led to a situation where they ended up with over 1,000 repossessed vehicles on their lot. In just 3 years, repossessed assets grew from $160,000 to over $6 million. As a result, that once-healthy credit union had to be purchased and assumed by another credit union. By any reckoning, the situation at that credit union was unacceptable. My job is to make sure that it's un-repeatable.

- Third, loan participations. So much of this industry is built on trust. We don't want to lose that. But when it comes to loan participation, that attitude needs to be modified a bit: Trust, but verify. These are the cases where a handshake isn't enough. Even if someone else claims to have done it, you need to do your own due diligence.

- Fourth and finally, we're looking at member business lending. I support increasing the cap on member business lending. It makes no sense to me that Congress put an arbitrary cap on the percentage of assets credit unions can lend in this way. Still, we all need to recognize that <u>commercial loans are risky</u>. Member business loan delinquencies are higher than any other type of loans – including real estate loans. Worse yet, MBL delinquencies are rising much faster than delinquencies on all other loans. So, if you are not doing your own due diligence – particularly on loan participations – you can expect a visit from your examiner.

So, looking forward, the red flags will be high concentrations of fixed-rate mortgages, and indirect loans, member business loans and loan participations where credit unions are not doing their own due diligence. Even if you are well capitalized – we won't wait 12-18 months. We will send an examiner sooner.

And we will step up public administrative actions to ensure compliance. If a credit union has not addressed NCUA recommendations contained in a <u>private</u> Document of Resolution, examiners will follow up with a <u>public</u> Letter of Understanding and Agreement – or in more severe cases, a public Cease and Desist order.

I was surprised to learn that some credit unions thought a Document of Resolution is optional. Let me assure you: It is not.

We are stepping up these actions to save as many credit unions as possible. Our hope is that credit unions will comply, and that we will not have to wind up merging, conserving or liquidating them. Tough times call for tough love.

And let me say clearly again that our intention in all of these efforts, from the corporate rule to our new budgeting and oversight, is not to over-regulate or play "gotcha." As we all know, the regulation pendulum tends to swing wildly as the economic winds change direction. NCUA is not attempting to over-compensate for a period of under-regulation by meddling in the daily operations of corporate and retail credit unions. NCUA is your partner in safety and soundness. Our goal is to detect and resolve problems before they become insurmountable.

The policies I have outlined will provide you support and, when necessary, intervention, to prevent potential crises that could impact the financial security of your members. But at the end of the day, we look to you as the ultimate guardians of your credit union's fiscal health.

So let me conclude with a few ideas for how you can help:

You can engage in diligent succession planning for your Boards of Directors. The safety and soundness of credit unions depends in large measure on a healthy, well-planned continuity of leadership on their volunteer boards. Volunteer leaders should make this a high priority of their service.

You can be active, well-informed and visionary, and should be questioning and challenging management's assumptions. You are your members' first line of defense in risk management, and right now, your utmost diligence is an absolute necessity.

And, you can focus on your fields of membership and their diversity, and help make sure that your board and staff reflect that diversity so that they can better understand your members' needs and respond to them.

I know that this is a lot of work to ask of volunteers. I am well aware that you volunteer not for any form of compensation, not for the recognition, not for any measureable perks. In fact, you have put yourselves in a position to endure criticism from those who point their finger anywhere to find a culprit for this economic crisis.

As volunteers, you are free to leave your position at any time. Nothing compels you to stay and work as hard as you do at this very difficult job, except your sense of civic duty and your belief that America's credit unions are worth fighting for.

You've never forgotten that credit unions were created to serve the people too often ignored by the for-profit financial institutions: farmers who needed loans until their harvest; families living in areas underserved by banks; and hard-working people who saved for years to buy a home and send their children to college.

These people – decent, hard-working Americans of modest means – are the heritage of credit unions. And in the eye of a vast economic crisis brought on by unchecked greed, irresponsibility and profit-taking, the values upon which credit unions were founded have never been as relevant as they are today.

Thank you for standing up to serve. I look forward to working with you in the months and years ahead, so that together we can seize this opportunity to safeguard our financial well-being and grow credit union membership from 90 million to 100 million and beyond.

Thank you very much.